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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1948

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# No. 313

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COMMISSIONER OF INTERNAL REVENUE

*vs.*

W. O. CULBERTSON, SR.

AND

GLADYS CULBERTSON

---

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

---

## BRIEF OF AMICUS CURIAE

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## MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE

---

The undersigned respectfully move this Honorable Court for leave to file the annexed brief as amicus curiae.


WILLIAM A. SUTHERLAND,
*Ring Building,*
*Washington, D. C.*

ARTHUR H. KENT,
*Mills Tower,*
*San Francisco, Calif.*

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## BRIEF OF AMICUS CURIAE

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The filing of this brief is prompted by the fact that the Solicitor General has asked this Court to construe the cases of *Commissioner* v. *Tower*, 327 U. S. 280 (1946) and *Lusthaus* v. *Commissioner*, 327 U. S. 293 (1946)—as he correctly contends that the Tax Court has construed them—as holding that where an interest in a partnership is donated by a husband (or a father) to his wife (or child) and the donee performs no vital services in the business, the income

must, as a matter of law, be taxed to the donor.[1] This is a question of great public interest and should be settled now by this Court contrary to the Government's contention, regardless of whether or not there are any other reasons for affirming the decision of the Court below.

Secondarily, we are interested in seeing a clear statement from this Court of what we believe to be the proper procedural steps to be taken by Courts of Appeals in reviewing decisions by the Tax Court where the Tax Court's decisions appear to have been grounded upon erroneous principles of law.

## A. The Legal Criteria Governing the Taxation of Income of Family Partnerships

### 1. *The Rule of Thumb Applied by the Tax Court*

In the present case, as in many other cases, the Tax Court has unquestionably construed the *Tower* and *Lusthaus* cases as laying down the proposition here urged by the Solicitor General, namely, that as a matter of law, a family partnership will not be recognized for income tax purposes in the case of any partner who did not contribute "original capital" or perform "vital services." In the present case, the Tax Court has not only applied this erroneous legal test, but has ignored realities in order to compress the facts to fit the legal mold which it has thus established.

That the Tax Court has so construed the *Tower* and *Lusthaus* cases is clear from an examination of the mass of opinions of the Tax Court in which that Court, notwithstanding the great variety of other facts present (on some of which perhaps there might have been adequate proof of a lack of reality of partnership), has applied a rule of thumb that if "original capital" and "vital services" are both lacking, the

[1] On Page 13 of the Petition for Certiorari the Solicitor General refers to the holding in the *Tower* and *Lusthaus* cases as: "This Court's holding in those cases that the incoming partner must actually contribute capital 'originating' with him (or else 'vital additional services') . . ."

wife or child's interest in the partnership will be ignored for tax purposes.[2] The trend of the Tax Court decisions is well analyzed in the Petition for Certiorari in the case of *Hyman Moore* v. *Commissioner*, No. 525, now pending before this Court.

It is apparent from the opinion in the present case that the Tax Court's consideration of this case was grounded upon the same erroneous interpretation of the law.[3]

Thus, while the *Tower* and *Lusthaus* cases applied to "family partnerships" the salutary rule that form could be disregarded in the search for substance or reality, the anomalous result of those decisions is that the Tax Court has in its decisions exalted form at the expense of substance,

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[2] *E.g.*, *M. M. Munroe*, 7 T. C. 278 (1946); *Paul G. Greene*, 7 T. C. 142 (1946); *Floyd D. Akers*, 6 T. C. 693 (1946); *Leonard N. Simons*, 7 T. C. 114 (1946); *John Lang*, 7 T. C. 6 (1946); *James L. Pritchard*, 7 T. C. 1228 (1946); *Edwin F. Sandberg*, 8 T. C. 423 (1947); *Robert H. Cole*, CCH Dec. 16,279 (M) (1948); *Margaret F. Horowitz*, CCH Dec. 15,843 (M) (1947); *Robert S. LeSage*, CCH Dec. 16,163 (M) (1947); *L. W. Seabrook*, CCH Dec. 16,172 (M) (1947); *Gil Graber*, CCH Dec. 16,218 (M) (1948).

[3] *William O. Culbertson, Sr.*, 6 TCM 692 (1947). The Tax Court's espousal of this interpretation is apparent throughout the opinion. For example, the court said:

> "Though the petitioner urges that many cattle businesses are composed of fathers and sons, and that the nature of the industry so requires, we think the same is probably true of other industries where men wish to take children into business with them. *Nevertheless, we think that fact does not override the many decisions to the general effect that partners must contribute capital originating with them or vital services.*" (italics added)

The Tax Court's acceptance of this interpretation and its rigid and mechanical application thereof is clearly manifest also in the cases of *Hartz v. Commissioner*, 170 F. 2d) 313 (C. A. 8th, 1948), *reversing* CCH Dec. 15,775 (M) (1947), in which a petition for certiorari is now pending before this Court (Oct. Term 1948, No. 520) and *Margaret F. Horowitz*, CCH Dec. 15,843 (M) (1947), appeal pending. In each of these cases, the Tax Court denied recognition to a partnership because it failed to satisfy the criteria of "original capital" and "vital services", although the facts found showed that the formation of the partnership was motivated primarily by clear and cogent business considerations.

as, for instance in the present case, holding that an ex parte document executed by one partner was the partnership agreement. The Tax Court has devised a formula—or "specifications for a husband and wife partnership"[4]—which excuses the careful weighing of evidence and permits the application of an over-simplified, rigid test in every case.

*2. The Decisions in the Tower and Lusthaus Cases*

This Court is now asked to confirm the Tax Court's construction of the *Tower* and *Lusthaus* decisions, and to deny tax effect to all partnerships—however real, and without regard to how large a part capital plays in the production of income—whenever it finds no contribution of capital originating with the wife (or child) and no vital services performed by such partner. Clearly the *Tower* and *Lusthaus* cases do not lay down any such rule.[5] And if any

[4] *Julius B. Black*, CCH Dec. 15,645 (M) (1947).

[5] Shortly after the *Tower* and *Lusthaus* decisions, the proposition was squarely presented to the Court of Appeals for the Fifth Circuit in the case of *Thomas v. Feldman*, 158 F. (2d) 488 (1946). In that case the taxpayers had transferred to trusts, created by them for the benefit of their minor children, certain shares of stock in two family corporations. Subsequently the corporations dissolved and the assets thereof were distributed to the respective shareholders, who organized two limited partnerships. In each of these partnerships, one of the taxpayers was the general and managing partner, and the trusts and other shareholders were limited partners. The court, with one judge dissenting, reversed the District Court and held that partnership income allocated to the trusts was not taxable to the taxpayers. The *Tower* and *Lusthaus* decisions were distinguished on the ground that in each of those cases the Tax Court had made a finding that the wife was not a genuine partner. The Solicitor General did not petition for certiorari.

The Solicitor General refers here to what he calls an "alarming tendency" of late for Courts of Appeals to reverse Tax Court holdings against the validity of family partnerships. The "alarming tendency" represents nothing more than an acceptance of the interpretation adopted in the *Feldman* case, and a realization that the powers of Courts of Appeals are not so restricted as to prevent a reversal of the Tax Court where it has applied the incorrect rule of law which it has drawn from the *Tower* and *Lusthaus* cases.

court should lay down such a rule, it would be guilty of an inexcusable invasion of the legislative field.

In the *Tower* case the majority of the Court concluded its opinion sustaining the Tax Court by stating:

> "Whether the evidence would have supported a different finding by the Tax Court is a question not here presented." (327 U. S. at 292.)

If the Court had intended to hold as a matter of law that the fact that a wife receives her interest in the partnership by gift and performs no vital services will nullify recognition of the partnership, the simple statement of that proposition would have disposed of that case, since admittedly those were the facts. However, the Court went at great length into the subject of the reality of partnerships, and referred to the presence or absence of a contribution of outside capital or vital services only to say that they are circumstances which may properly be taken into consideration in determining whether a partnership is real.[6] In fairness to the Tax Court and to the Solicitor General, however, it should be admitted that Mr. Justice Rutledge, in concurring, criticized the majority for not stating that as a matter of law a decision by the Tax Court in Mr. Tower's favor would have been error;[7] and that Mr. Justice Reed, with whom the Chief Justice concurred in dissenting, felt that the majority opinion could be construed as the Solicitor

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[6] Mr. Justice Black, speaking for the Court, said:

> "A wife may become a general or a limited partner with her husband. But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court *may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws.*" (italics added) (327 U. S. at 290)

[7] Mr. Justice Rutledge did not state what legal criteria he considered controlling, and he gave no indication that he accepted the rule of thumb which the Solicitor General here urges.

General now contends. We repeat again, however, that this Court enunciated no such principle.[8]

### 3. *Statutory Provisions Involved*

Upon what statutory provisions is the Tax Court's rule of thumb based? Nothing in the Internal Revenue Code lends the slightest support for the proposition that the gift of an interest in a partnership in which capital is a large income-producing factor leaves the income taxable to the donor and not to the donee who owns the income produced and the property which produced the income. It is interesting to note that in the petition for certiorari and the brief memorandum filed after the granting of certiorari, the Solicitor General does not cite any statutory language whatsoever as a basis for his contention.

Internal Revenue Code, Section 182, which provides for the taxation of the income of members of a partnership, expressly says:

> "Sec. 182. TAX OF PARTNERS.
>
> In computing the net income of each partner, he shall include . . .
>
> (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in Section 183(b)."

These words make it perfectly clear that the income of a partnership is to be taxed to the person to whom the income is to be distributed.

We will readily concede that this section should be read in the light of the general assumption that partnership in-

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[8] A number of District Judges have construed the *Tower* and *Lusthaus* cases as not laying down the narrow rule which the Tax Court has been applying, and—without objection by the Government—have submitted cases to juries on charges which made taxability depend on the reality of the partnership under all the facts and not on the rule of thumb here urged by the Solicitor General. See, *e.g.*, reports of charges to juries in the following cases: *Knott v. Allen*, 47-1 USTC ¶ 9230; *Mallary v. Allen*, 47-2 USTC ¶ 9399; *Riggs v. Thompson*, 48-2 USTC ¶ 9353.

come is to be distributed in proportion to each partner's bona fide interest in the partnership business, and that where the partnership has been used as a mere device for the allocation of income from personal services to persons who did not perform such services, the rationale of the case of *Lucas* v. *Earl*[9] would justify the Commissioner in requiring a reasonable allocation for salaries before dividing the partnership profits among the partners. But this salutary rule cannot justify any similar refusal to recognize the partnership insofar as the partnership income is due to the capital invested. The rule of *Lucas* v. *Earl* does not violate the basic principle of law that income from property is to be taxed to the owner of the property.

Neither does the *Horst*[10] case or cases following it in any way support the contention which the Solicitor General here makes. The *Horst* case held that an assignment of income from property would not be recognized for income tax purposes where the property itself was not assigned. Certainly in a family partnership case if there were no effective and complete transfer of the partnership property the income from which is at issue, the Commissioner would be justified in taxing the partnership income to the person who retained the partnership property. But in the situation now being considered: (1) there was a completed and bona fide gift of a property interest in a partnership, (2) the partnership income at issue arose subsequent to that gift, and (3) the transferred property interest in the partnership was a substantial income-producing factor. The *Horst* case, if at all relevant to this situation, would support the taxation of the income from the property to the owner thereof.

What the Solicitor General now asks is that a property interest in a partnership be treated differently from any other type of property interest. Not a word in the Internal Revenue Code suggests that the income from a partnership interest which has been donated completely and in good

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[9] 281 U. S. 111 (1930).

[10] *Helvering v. Horst*, 311 U. S. 112 (1940).

faith to a member of a family may be taxed to the donor. And certainly, in the absence of some Congressional expression, no court should assume the authority to lay down such a rule.

4. *Property Interests in Partnerships Compared with Other Property Interests.*

It is clear that where real property or personal property, tangible or intangible, is donated outright and in good faith to a member of the family, the income thereafter arising will be taxed to the donee and not to the donor.[11] It makes no difference whether the property is corporate stock, an office building or a threshing machine.

Nor does it matter whether the donee participates in the management of the property. The donor may continue to manage it as husband or guardian. In fact, the property may be stock of a corporation in which the donor owns the majority of the stock and therefore is in a position legally to direct the management and control of the business to a much greater extent than is true in the ordinary partnership and just as fully as in a limited partnership. Or the donor may transfer the property to himself as trustee for his wife or child, vesting in himself full powers of management, and the income will be taxable to the donee as in the case of an outright gift, so long as the rights retained by the donor out of the bundle of rights which make up the property are not so large as to bring the transfer within the purport of the *Clifford*[12] case and the cases and regulations[13] which follow it. Upon what statutory basis or theory of income tax law a transfer of a property interest in a partnership is to be treated differ-

[11] *Blair v. Commissioner*, 300 U. S. 5 (1937).

[12] *Helvering v. Clifford*, 309 U. S. 331 (1940). In *Harrison v. Schaffner*, 312 U. S. 579 (1940) the owner of property had put it in trust for one year retaining most of the ownership and control and was held taxable during that year. He had given away only a minimum of rights in the property—substantially only the income.

[13] U. S. Treas. Reg. 111, Sec. 29.22(a)-21.

ently, the Solicitor General does not attempt to explain, nor has anyone else attempted to explain it.[14] Certainly no explanation has come from the Tax Court which has done nothing but follow what it conceives to be a rule of thumb laid down in *Tower* and *Lusthaus*.

The opportunity for fraud in family partnerships does not justify the Solicitor General's contention. In all cases of transfers within a family group there is great opportunity for fraud. Many sham transactions are found in the outward cloaks of reality, and this is no less true of transfers within the family group of interests in partnerships than of transfers of other property interests, and probably no more so. And in many cases involving all different sorts of property it is difficult to distinguish the real from the sham. But this fact does not justify a rule of law which will disregard for tax purposes all partnership transfers in the family group any more than it would justify a rule which would disregard all transfers of other property. Until Congress sees fit to pass a statute embodying such a rule of law—which it certainly will not—it is not the function of the courts to create any such rule.

No doubt, as was the situation in the *Tower* and *Lusthaus* cases, although not in the present case, many transfers of family partnership interests have been motivated by a desire to save taxes. But the same is true of transfers of all other sorts of property. If such transfers are apparent and not real, they are properly disregarded. The only im-

[14] It is fundamental in the law that a managing partner is no more free to use property as his own than is a managing trustee. Of course, it is always possible that a father—whether trustee, guardian, partner, or joint tenant—may misuse his position and treat as his own what belongs to a wife or child, and the chances are that he will not suffer the same consequences as if he were dealing with a stranger. But certainly there is no presumption that a father will so violate the law, and Congress has never endorsed any intention to treat the power to violate the law as divesting the interest, for tax purposes or otherwise, of the wife or child. And this consideration would no more justify ignoring the tax results which the statutes attach to partnership activity than the statutory results attaching to activity involving other forms of property.

portance of the tax avoidance motive, where it is present, is for whatever bearing it may have in the determination of the fact of reality or sham,[15] and that is no more and no less in partnership cases than in other cases.

5. *Congressional Attitude on Taxation of Family Partnerships.*

Judicial legislation, even to attain a goal which the court feels certain Congress would achieve, if it considered the problem involved, is entirely unjustifiable under our constitutional system. Moreover, in the family partnership field, there is no indication whatsoever that Congress has ever or would ever approve such an arbitrary rule of law as that the Government here urges. The indications of Congressional opinion that we do have on the subject indicate that Congress would expressly repudiate any such rule of law. Thus the Government's contention would reach a result contrary to the legislative will.

Extensive criticism of the erroneous standards being applied to family partnerships by the Commissioner and the Tax Court was presented to the Ways and Means Committee by the organized Bar and by many other groups and individuals during the hearings that body held recently

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[15] It is well in this field to revert frequently to the language of Judge Learned Hand in *Chisholm* v. *Commissioner*, 79 F. (2d) 14 (C. C. A. 2d, 1935), where he said:

> "*The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive another; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance.* True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, *but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation* . . ." (italics added) (79 F. (2d) at 15).

on the subject of revenue revisions.[16] The American Bar Association's resolutions and statement, which denounced the rules being applied as completely unjustified under the law, are printed as an appendix to this brief.[17] *Supra*, p. 17. Following these hearings, the Ways and Means Committee approved, and the House of Representatives passed, provisions which would eliminate retroactively the Tax Court's rule of thumb. The provisions did not reach the Senate in time for consideration.

The following explanation of these family partnership provisions was made by the Ways and Means Committee:

> "Legislation on family partnerships is deemed necessary because the lower courts and those administering the tax laws have taken the position that the Supreme Court's decision in the *Tower* and *Lusthaus* cases in 1946 limits the recognition of partner status in a family partnership to those who have contributed capital originating with themselves or who have performed vital additional services. At present no question is raised, however, if a husband makes a completed gift to his wife of stock in a family corporation. The gift is recognized, and the dividends paid on the stock are taxed as income to the wife. Nor would the courts or the administrative officials refuse to recognize for income tax purposes the income of a wife from rental property received as a bona fide gift from her husband.
>
> "The bill removes this discrimination with respect to the current and future years and also for open years back to 1941." (H. Rep. 2087, 80th Cong., 2d Sess., p. 10)

Nor has criticism been limited to the House of Representatives. Debate on the floor of the Senate on May 27 and May 28, 1947, showed a general disapproval of the position which the Commissioner and Tax Court have

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[16] *See, e.g., Hearings before the Committee on Ways and Means on Revenue Revisions 1947-48*, 80th Cong., 1st Sess. (1947) 3199-3200, 967-969, 898, 903, 939-940, 3599.

[17] *Ibid*, pp. 3344-46, 3360.

taken.[18] This disapproval was voiced by leaders on both sides of the issue involved in that particular debate.[19]

It is most fortunate that the question of family partnerships is again before this Court before further statutory provisions have been added to the Internal Revenue Code to cover a group of situations which can readily be handled by the administrators and the courts under the present statutory provisions if properly interpreted.

## B. The Proper Review of Tax Court Decisions Where Tax Court Has Applied Erroneous Principles of Law

Assuming as we do that this Court will not approve the construction which the Tax Court has placed on the *Tower* and *Lusthaus* cases, the question then arises as to the proper duty of a Court of Appeals on an appeal from the Tax Court, where the Tax Court has proceeded upon erroneous legal premises. The question involved is a fundamentally important one, and this court should make its answer clear.

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[18] See, *e.g.*, 93 Cong. Rec. 5987, 5988 (May 27, 1947); 93 Cong. Rec. 6069, 6070, 6071, (May 28, 1947).

[19] For example, Senator George, now Chairman of the Senate Finance Committee and Chairman of the Senate Finance Committee for a number of years prior to the 80th Congress, said:

> "The Treasury has very vigorously pushed the cases against the so-called family partnerships. *I think, and I have said so to the Treasury, and I have said so openly in the hearings in the Finance Committee, that they have gone entirely too far.* . . . If the husband makes money and pays all the taxes due upon that money, and if after having paid his taxes he wishes to give the wife an interest in a partnership business or give her money which she puts into that partnership business, there should not be laid down in those cases the narrow test which our courts, I regret to say, have recognized, to wit, whether the wife actually contributed anything by way of work or by way of attention or by way of management of the business. *That ought not to have been the test.* (italics added) 93 Cong. Rec. at 6071 (May 28, 1947)

Findings of fact on disputed evidence and the factual inferences to be drawn from the primary facts are obviously for the Tax Court. Where the findings and inferences are such as could reasonably have been reached on the basis of the evidence, the Tax Court, like a District Court, should be sustained on appeal even though the appellate court might have reached a different conclusion in a trial *de novo*. However, an entirely different question is presented where in determining the so-called ultimate fact of the case—in these cases the "reality" of the partnerships—the lower tribunal has proceeded upon erroneous principles of law and has not attempted to determine "reality" as a fact but has proceeded only to find out whether the subsidiary facts of the cases are such as to bring the alleged partnerships within an incorrect principle of law.

In this situation, of course, the ultimate finding is ambiguous, and the appellate court must either (1) remand the case to the trial court with directions to the trial court to determine the facts in the light of the proper legal principles, or, (2) make its own findings of fact. Generally, where the facts are so clear that only one conclusion can be reached by the trial court the case may be finally decided by the appellate court; otherwise the case should be remanded for findings in the light of the correct legal principles laid down by the appellate court. In many cases coming from the Tax Court these procedural principles have been ignored.

One of the duties of an appellate court, especially in the tax field where litigation is so prolific, should be to require the trial court (here the Tax Court, which is required to make findings of fact and conclusions of law) to word its findings and conclusions so as to make the basis of its ultimate decision clear. If the Tax Court opinion is ambiguous as to whether the decision is based upon erroneous principles of law, the appellate court should remand the case for the necessary clarification. Frequently

this is the only procedure which will insure fairness to the litigants and clarify the law for the future.[20]

In the principal case, which clearly proceeded upon an erroneous principle of law, there is no question but that the court below should be reversed. From the brief consideration which we have given to the facts in this particular case, it would seem that the Court of Appeals was correct in deciding the ultimate issue. But the least that it could have done, was to reverse and remand with directions that the Tax Court consider the final question in the light of the correct legal principles applicable.

## Conclusion

Confusion and injustice have resulted from a misinterpretation by the Tax Court of this Court's opinion in the *Tower* and *Lusthaus* cases. A clear statement of the correct principles by this honorable Court would relieve the present congestion in the administrative handling of these cases and permit a fair trial of them before any tribunal. It is also important that this Court recognize the power of Courts of Appeals to reverse the Tax Court in any case where the Tax Court makes an ultimate finding of "fact" through the application of erroneous principles of law.

Respectfully submitted,

WILLIAM A. SUTHERLAND,
ARTHUR H. KENT,

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[20] This procedure was followed by the Court of Appeals for the Fifth Circuit in the case of *Mitchell v. Commissioner*, 118 F. (2d) 308 (C. C. A. 5th, 1941), *reversing and remanding* 40 B. T. A. 424 (1939). In that case, the Court of Appeals could not tell from the Tax Court's decision the basis of the Tax Court's ultimate conclusion of fraud. It was not clear whether the Tax Court intended to conclude from the facts that the taxpayer knew that his income tax return was false when he filed it, or whether the Tax Court felt that the fraud could be based upon the gross negligence of the taxpayer. Upon remand, the Tax Court reversed its ultimate finding in the light of the pertinent questions asked by the Court of Appeals.

## APPENDIX

**Resolutions and Statement of the American Bar Association Dealing With Tax Status of Family Partnerships, Presented to the Ways and Means Committee of the House of Representatives on December 8, 1947.**

(Quoted from *Hearings Before Committee on Ways and Means on Revenue Revisions, 1947-48*, 80th Cong., 1st Sess. (1947), 3344-46)

10. *Federal income tax—Clarification of tax status of so-called family partnerships.*

The tenth resolution is as follows:

"*Resolved*, That the American Bar Association recommends to Congress that the provisions of the Internal Revenue code relating to the definition of partnerships be amended to clarify the income tax status of so-called family partnerships, in accordance with the generally recognized principle that the income from purchased or donated property is taxable to the bona fide purchaser or donee of such property; and be it further

"*Resolved*, That the association proposes that this result be achieved by amending section 3797 of the Internal Revenue Code; and be it further

"*Resolved*, That the officers and council of the section of taxation are directed to urge the following amendment or its equivalent in purpose and effect, in the proper committees of Congress:

"'Section 3797 (a) (2) of the Internal Revenue Code is hereby amended by adding thereto after the period at the end thereof the following:

"'"If a person is otherwise recognized by law as a bona fide partner or joint venturer, he shall be considered a partner for the purpose of this title if he has contributed capital or substantial personal services to the partnership. For the purpose capital shall be deemed to include any money or other property (including an interest in the partnership or in a predecessor business) acquired at any time from any other person by bona fide purchase or gift. If in any case, however, the interest of any partner was acquired, directly or indirectly, from another person, and if the partner is a spouse, brother or sister (whether by the whole or half blood), ancestor or lineal descendant of such other per-

son, or if the partner is a trust of which such other person is the grantor,

> "'"(i) if such other person has an investment in the partnership, the proportion which the acquiring partner's distributive share of partnership income bears to his capital shall not exceed the proportion which such other person's distributive share of partnership income bears to such other persons's capital (unless such excess is attributable to personal services actually rendered by the acquiring partner), and any excess shall be considered additional income of such other person; and
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> "'"(ii) if the partnership agreement requires the distributive shares of partnership income to be determined without reasonable allowance for personal services rendered by such other person, there shall be attributed to such other person an amount not in excess of reasonable compensation for such services, and there shall be deducted from the distributive share of the acquiring partner his proportionate share of such amount."'"

*Comment*

It is a basic principle of income taxation that income derived from property is taxable to the bona fide owner of that property, whether such ownership was acquired by purchase or by gift, and whether it was acquired from a stranger or from a relative. The Supreme Court has never questioned this basic principle. Nevertheless in *Commissioner* v. *Tower* (327 U. S. 280 (1946)), and *Lusthaus* v. *Commissioner* (326 U. S. 293 (1946)), the court stated that a partnership between husband and wife, valid under local law, may be disregarded for income tax purposes if the partnership is not "real." Moreover, the court indicated that one of the criteria which the Tax Court can consider in determining "reality" is whether or not the property contributed by the wife "originated" with her. The Tax Court has apparently interpreted these decisions to mean that a partnership is invalid unless the wife renders substantial services or unless she has contributed "original" capital. The Tax Court has apparently considered it immaterial that capital is itself a significant income-producing factor in the business, and that the wife may be the absolute owner of

part of that capital even where she derived the capital originally by gift from her husband.

The fundamental fallacy of the rule presently being applied by the Tax Court is indicated by some of the distinctions which the courts have been forced to make in its application. For example, if the husband made a gift to his wife before the partnership was contemplated, and if the wife subsequently contributes this gift as her partnership capital, the wife's partnership interest is recognized for tax purposes (*S. E. Boozer*, C. C. H., T. C., Dec. 16,008 (M) (Aug. 28, 1947)). But if the same gift consists of capital in an existing business, the entire partnership income is taxed to the husband (*Commissioner v. Tower*, supra). Where the wife purchases her interest from another partner of the husband, her interest is recognized for tax purposes, even though she has borrowed part of the purchase price on the husband's collateral (*S. Kenneth Alexander*, 6 T. C. 804 (1946)). Where, however, the wife purchases her interest directly from the husband, the partnership is invalid and all of the partnership income is taxed to the husband where the loan is to be repaid from the partnership income (*Lusthaus* v. *Commissioner*, supra; *W. A. Belcher*, 7 T. C. 182 (1946), affirmed, 162 F. (2d) 974 (C. C. A., 5th, 1947)). On another aspect of the problem, the courts are in conflict as to whether capital contributed by the wife before the formation of the partnership is sufficient to validate the partnership (*Singletary* v. *Commissioner*, 155 F. (2d) 207 (C. C. A. 5th, 1946)), reversing 5. T. C. 365 (1945); cf. *Thorroz* v. *Commissioner*, 155 F. (2d) 791 (C. C. A. 6th, 1946)).

In one case, income of an "invalid" partnership was distributed to the wife; she used this income to purchase property which she leased to the partnership for a fair rental. The Tax Court held that, although the original partnership income was taxable to the husband, the rental income was taxable to the wife (*Abe Schreiber*, 6 T. C. 707 (1946), affirmed, 160 F. (2d) (C. C. A. 6th, 1947)). On the other hand, if the wife allows her income to remain in the partnership, even the subsequent earnings attributable to such income are apparently taxable to the husband (*Margaret F. Horowitz*, C. C. H. T. C. Dec. 15, 843 (M) (June 12, 1947); cf. *Durwood* v. *Commissioner*, 159 F. (2d) 400 (C. C. A. 8th, 1947)). It has been emphasized in many cases that the "tax avoidance" purpose of the gift is the essential

weakness. See *Scherf* v. *Commissioner*, 161 F. (2d) 495 (C. C. A. 5th, 1947). Yet, the Tax Court has refused to recognize a partnership even where it has found that the partnership was formed solely for business reasons (*Margaret F. Horowitz*, supra).

These examples are not cited to demonstrate a need for statutory refinements of the problem. Starting with the fundamental fallacy, the courts have been struggling as well as they can to draw intelligent distinctions. The examples simply illustrate the kind of finespun logic which is the inevitable result of a fallacious premise. What is needed is a basic statutory correction of the fundamental error.

Such a correction might at first thought seem to be a simple matter. Several simple proposals have been advanced. One would recognize any partnership which is valid under local law. Another would simply recognize the validity of donated capital. However, in the opinion of a majority of those considering the problem, the tangled history of this issue makes such simple solutions undesirable. If the "family partnership" rule had developed in conformity with the basic principles of income-tax law, and without the confusion created by decisions such as those in the Tower and Lusthaus cases, supra, no specific statutory provision should have been required to enable the Bureau and the courts to have created adequate safeguards against unjustifiable tax avoidance. A blanket statutory recognition of all partnerships in the 1948 general tax revision, however, might have the effect of eliminating such safeguards as would have been developed. The recommended amendment of the bar association, therefore, specifically sets forth the following safeguards:

1. The wife (or other family member) must contribute either capital or substantial personal services. The wife, therefore, may not have income diverted to her as a partner in a purely personal service business unless she actually renders substantial services.

2. If the wife's capital was acquired from the husband, it must have been by bona fide purchase or gift. If the husband retains such "strings" as to negate the wife's ownership, the wife's interest is not recognized. But the extent of the wife's ownership is determined by State law, and not any separate criteria of the Federal tax law.

3. Income derived from capital may not be shared in substantial disproportion to capital accounts. That is, the

husband may not give the wife a 10-percent interest in the capital of the business, and divert to her 50 percent of the income.

4. Income derived from the husband's personal services may not be deflected to the wife. If the husband renders personal services to the partnership, and if the partnership agreement makes no provision for reasonable compensation, the Commissioner may allocate a reasonable salary to him before accepting a division of the business income.

It is believed that the statute recommended by the bar association is a fair statement of the law as it existed prior to the Tower case, that it merely reestablishes that law, and that it is in harmony with the general principles of income taxation.